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The Origin of the Network Positions of New Organizations: How Entrepreneurs Raise Funds

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ABSTRACT

This dissertation examines the mechanisms by which entrepreneurs successfully raise venture capital. Although there has been substantial research on the benefits of having venture capital, how entrepreneurs successfully raise venture capital has received scant attention. I address this gap using two complementary methodologies. First, I develop hypotheses from two competing theoretical logics, one based on founder network ties and status and the other based on accomplishments, that I statistically test in a study of venture capitalists and corporations investing in 92 Internet security ventures. Second, building on a number of detailed interviews with the entrepreneurs at and investors in nine of these ventures, I induct a theoretical framework describing the actions that entrepreneurs used to successfully raise venture capital. In both portions of the dissertation, I find that there are strategies which allow even relatively unknown and poorly-connected entrepreneurs to successfully raise venture capital.

INTRODUCTION

How do entrepreneurs successfully raise venture capital? Venture capital funding is an important mechanism for the financing of young ventures, and it has played an important role in the development of many new markets over the last several decades, including the Internet, the semiconductor industry, and biotechnology. When a firm accepts a venture capital investment, it sells a portion of its equity in exchange for capital and advice. Furthermore, numerous studies have found that accepting venture capital offers many benefits to ventures, including an improved likelihood of survival, a faster rate of growth, and a greater chance of either having an IPO or being acquired.

Yet despite the many benefits of accepting venture capital investments, prior research suggests that entrepreneurs may face many obstacles inhibiting their ability to raise such professional investments. First, many entrepreneurs may simply lack either a viable business idea or the skills necessary to successfully launch and grow a venture. For these entrepreneurs, it is understandable that they may be unable to raise venture capital. Second, even entrepreneurs who have recognized a truly promising opportunity and who have the necessary skills to pursue that opportunity may have trouble distinguishing themselves from lower quality entrepreneurs. Thus, it is not surprising that researchers have found that, in some regions, less than five percent of entrepreneurs who approach investors ultimately receive an investment[1] and that even amongst those ventures that ultimately succeed in finding investors, the process typically takes 5 months[2].

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[1] Kirsch, D., Goldfarb, B., and Gera, A. 2006. "Business Plans and VC Investment Choices." Working Paper, University of Maryland.

[2] Bruno, A. V. and Tyebjee, T. T., 1985. "The Entrepreneur's Search for Capital." Journal of Business Venturing, 1: 61-74.

Though prior research has illuminated the many barriers that entrepreneurs may face in their quests to raise venture capital, there is surprisingly relatively little research on the strategies that entrepreneurs may use to successfully raise venture capital. What research has been conducted in this area has primarily emphasized the importance of entrepreneurs being introduced to venture capitalists through a mutual acquaintance. Additional research has also touched on the value of "high status" entrepreneurs whose prior entrepreneurial endeavors (e.g., having previously founded a successful startup), work experience at prominent companies (e.g., having been a vice president at Microsoft), or academic qualifications (e.g., having been a professor at Stanford), help distinguish them from lower quality entrepreneurs. Collectively, prior research suggests that entrepreneurs will be more successful in raising venture capital if they are well-connected and high status.

Yet this picture of raising venture capital appears incomplete for a few reasons. First, anecdotal evidence reveals that many entrepreneurs succeed in raising venture capital, often from top-tier investors, despite being neither particularly well-connected or particularly distinguished. Second, recollections of many well-connected and distinguished entrepreneurs reveal that they too encountered substantial difficulties as they sought to raise venture capital. In short, it appears that the successful raising of venture capital doesn't exclusively necessitate that entrepreneurs be well-connected or distinguished, nor do these qualities appear to be sufficient to ensure that raising is quick and successful. Overall, there is limited research on how entrepreneurs successfully raise venture capital, and many questions about the subject remain. In this dissertation, I have

thus sought to address these gaps by developing a more sophisticated and nuanced understanding of the means by which entrepreneurs successfully raise venture capital.

I explore this gap using two complementary methods. One is a quantitative, statistical analysis that tests theoretical hypothesis regarding which initial relationships form in a population of 92 Internet security ventures and 1,644 venture capital and corporate investors. The other is an inductive, multiple-case study of how nine of these ventures formed a series of investment relationships during their early years; this multiple-case study builds on detailed interviews with both the entrepreneurs and their investors. This inductive study uses granular and longitudinal field data from both entrepreneurs and their investors. Using the combination of these methods allows for the simultaneous exploration of related questions that would be difficult to address well using a single methodology.

Which Investors are likely to Initially Invest in a Venture

In the quantitative, statistical portion of the study, I explored the question of which venture capitalists are likely to be the initial investors in a venture. I did so using two competing logics. First, using a social inheritance logic consistent with the prior literature, I argued that ventures inherit the social ties and status of their founders, and that these inherited ties and status are the primary determinants of which investors are likely to initially invest in a venture. Under this logic, ventures are most likely to receive investments from investors that their founders either directly know or that are of a similar status to the new organization's founders. In a competing accomplishments logic, I then argued that who initially invests in a venture instead depends primarily on the venture's

early accomplishments, and that ventures with more accomplishments relative to their peers will be more likely to initially receive investments from higher-status investors. Thus this second logic breaks from previous research on raising venture capital in suggesting that which investors initially invest in a venture primarily depends on what founders achieve after the venture's founding – and not who the founders were or who they knew prior to the founding. Finally, as achieving meaningful accomplishments often takes time, I explored how the relative influence of these logics may shift as a venture ages.

I tested these theoretical propositions using a statistical, rare-event logit analysis to examine investment likelihood in a choice-based sample of 92 Internet security ventures receiving investments from 1,644 venture capitalists and corporate investors. These tests generally support the developed theory. That is, they show that there are two paths by which entrepreneurs may obtain high-status venture capital investors. For entrepreneurs that raise venture capital soon after founding their venture, I found that their personal ties and status are the primary determinants of which venture capitalists are likely to invest. However, for entrepreneurs that wait to raise venture capital, I found that which venture capitalists invests instead depends primarily on the venture's accomplishments since it's founding. Finally, regardless of which path is taken for the initial investments, I found that who the initial venture capital investors are is the primary determinant of which venture capitalists are likely to invest in subsequent rounds. Thus entrepreneurs that fail to obtain high-status, well-regarded investors initially will be unlikely to do so later on.

This quantitative analysis has several important implications for both entrepreneurs and related theory. First, I show that entrepreneurs may use either their social capital (i.e., their personal network ties and status) or their human capital (i.e., their ability to help their venture release a product or win an award) to raise venture capital. Thus, even poorly-connected and low-status entrepreneurs may succeed in raising funds from high-status, top-tier venture capitalists - if they are careful to delay their attempt until after they have distinguished their venture through outstanding accomplishments. Second, I show that the windows for entrepreneurs to leverage their social capital or human capital are narrow and distinct, with the window for leveraging social capital lying in the first year of a venture's life, while the window for leveraging human capital extends until a venture has taken its first venture capital investment. Third, I observe that even controlling for a venture's later accomplishments, which venture capitalists initially invest in a venture is the primary determinant of the later investors – thus making the raising of initial funds an especially important and unique event that has a long-lasting impact on a venture.

Actions for the Quick and Successful Raising of Venture Capital

I then complement the statistical, quantitative portion of the dissertation with an interview-based, multiple-case portion that explores the actions that entrepreneurs use to successfully raise venture capital. Through detailed interviews with entrepreneurs and their investors, I found out how entrepreneurs at nine Internet security ventures located throughout the United Statues went about trying to raise funds from venture capitalists. I then engaged in an iterative process of contrasting the actions of entrepreneurs successful

in raising venture capital with the actions of entrepreneurs who were less successful in raising venture capital.

Through this iterative process, I inducted a theoretical framework describing the actions by which resource-poor entrepreneurs move beyond their personal networks and status to successfully raise venture capital. Under this framework, I surprisingly found that entrepreneurs were able to simply rely on their social networks, personal status, or their venture's accomplishments to convince venture capitalists to invest. Rather, I observed that raising venture capital required that *all* entrepreneurs engage in a set of specific actions in order to persuade investors to invest.

I found that many entrepreneurs encountered substantial difficulty in trying to raise venture capital as they believed that they needed to simply convince investors that their venture was of high-potential and that they possessed the personal skills necessary to grow the venture. And while investors did appear concerned about these factors, I observed that fundraising was further complicated by psychological tendencies, with these tendencies making investors extremely hesitant to move forward on a possible investment while at the same time making entrepreneurs especially gullible and prone to overestimating the interests of investors. In particular, and related to the psychology literature on *suspicion*, I observed that investors were reluctant to invest in entrepreneurs until after a period of prolonged and varied interaction and that investors insisted on this period regardless of an entrepreneur's status. Additionally, and related to the psychology literature on the inability of individuals to *evaluate complex attributes*, I observed that investors effectively ignored intermediate signals of a venture's progress (e.g., having a prototype of a product), instead focusing on the presence or absence of simple and

substantial signals (e.g., having a customer using the product). Furthermore, and related to the psychological tendency of individuals to be *risk-averse* when seeking gains, I observed that investors often avoided making investment decisions as long as possible. Finally, I also observed that entrepreneurs encountered difficulties due to their tendency to *interpret information favorably*, with many entrepreneurs overestimating the extent of an investor's interests – thus leading many entrepreneurs to unduly allocate time and energy towards unlikely investors. Overall, I found that successfully raising venture capital is more complicated and difficult than portrayed by previous research, as various barriers related to the psychological tendencies of involved individuals must be overcome.

However, I also discovered a set of actions that some entrepreneurs used to overcome these barriers and thus successfully raise venture capital. In general, these actions complemented an entrepreneur's existing signals of quality (e.g., either their network ties, status, or the venture's accomplishments). First, I found that instead of approaching potential partners at the time that they wished to raise venture capital, successful engaged in a process of *"casual dating"* months in advance of the intended investment, while avoiding explicit discussions about an investment during this dating period. Second, instead of pursuing investors when an investment would be most helpful, successful entrepreneurs timed their approach around *simple and substantial signals* of venture's progress, often raising before they needed the capital or even ignoring pressing capital needs in order to delay raising until after such signals were available. Third, rather than passively waiting for interested investors to commit to an investment, successful entrepreneurs pressured investors by creating *credible alternatives and deadlines*. Fourth,

instead of allocating their attention on the basis of how interested investors said they were, successful entrepreneurs were careful to allocate their attention on the basis of the *unintentional information* that investors inadvertently disclosed through either their interactions with other investors or through their actions in interacting with the entrepreneurs. Overall, the importance of these actions point to a more nuanced and psychologically informed view of raising venture capital. Additionally, this research also contributes to the literature on the value of social capital, offering the insight that capturing the value of social ties and status is often neither automatic nor straightforward, and is instead contingent on the use of non-obvious and difficult complementary actions.

Discussion

Together, these studies explain how entrepreneurs successfully raise venture capital. Though prior research has primarily emphasized the importance of an entrepreneur's prior ties and status, it has not explored how novice entrepreneurs lacking such ties or status may raise venture capital. Additionally, the prior literature has not considered the difficulties that even well-connected and well-known entrepreneurs might encounter. In this dissertation, I have sought to redress this gap by providing the insight that an entrepreneur's success in raising venture capital depends on a combination of his or her ties and status, the achievements of the venture since it was founded, and his or her use of necessary and complementary actions.

In both studies, I found that the tactics of entrepreneurs play a large role in their success in raising venture capital. Specifically, in the first study, I found that entrepreneurs seeking top-tier investors should alter their choice of when to raise venture capital based on whether they possess greater social capital or human capital. In the

second study, I found that irrespective of their connectedness and status, entrepreneurs were more successful in raising venture capital if they also engaged in appropriate persuasive actions. Yet, I observe that many entrepreneurs fail to use such appropriate and beneficial actions. Collectively, these findings highlight the extent to which an entrepreneur's success in raising venture capital depends on the tactics that he or she uses to do so, and that this use of appropriate tactics is more important than whether or not the entrepreneur came in well-connected and well-recognized. Furthermore, this suggests that a lack of awareness of appropriate tactics may often underlie many of the difficulties that entrepreneurs encounter. In summary, I have identified a set of tactics that may help entrepreneurs, whose venture is of sufficient potential, raise venture capital more quickly and successfully.